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No. 89-1233

IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

ESTATE OF LOUIS YAEGER, DECEASED, JUDITH WINTERS, RAPHAEL MEISELS, ABRAHAM K. WEBER, AND THE BANK OF NEW YORK, EXECUTORS,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY MEMORANDUM FOR THE PETITIONER

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This reply to the Government's brief in opposition is filed for two reasons. First, the Government has raised an argument which was made by the Commissioner in the Tax Court, which the Tax Court rejected, and which was not asserted by the Government in the Second Circuit. This reply is also submitted to point out a relevant authority which was decided by this Court after the petition for certiorari in this case was filed.

In the Tax Court, the Commissioner argued that property constituting a capital asset whose sale would result in a long-term capital gain is, *per se*, investment property and that interest incurred to purchase or carry such property is, *per se*, investment interest, whether or not it is incurred in connection with a trade or business. This argument was rejected by the Tax Court below (Pet. App. 25a-26a) and has been repeatedly rejected by the Tax

Court. *See, e.g., Polakis v. Commissioner*, 91 T.C. 660 (1988); *King v. Commissioner*, 89 T.C. 445 (1987).

In effect, the Commissioner had argued before the Tax Court that it is the nature of the property, and not the nature of the activities of the taxpayer, which governs whether or not interest is investment interest subject to the limitation of section 163(d).[1] The Government appeared to abandon this argument when the case was before the Second Circuit Court of Appeals. In its brief to the Court of Appeals, the Government conceded that "Section 163(d) does not apply to interest paid to acquire property used in the taxpayer's trade or business . . .", citing as authority the fact that "the House Report states that 'interest on funds borrowed in connection with a trade or business would not be affected by the [section 163(d)] limitation'. H.R. Rep. No. 413, pt. 1 (1969), *supra* at 73." (Gov't. Brief to 2d Cir. at p. 18.)

In its opposing brief (Brief in Opp. at pp. 10-13), the Government appears to revert to the argument rejected by the Tax Court that it is the nature of the property, and not the nature of the activities of the taxpayer, which determines whether section 163(d) applies to the interest expense. In support of its argument, the Government characterizes the Congressional mandate that interest incurred in a trade or business is excluded from the reach of section 163(d) as merely indicating Congress' anticipation that interest incurred in carrying on a trade or business would not be affected by section 163(d). However, this position is directly contradicted by the following statement of the House Ways and Means Committee when section 163(d) was enacted:

> This limitation is to be applicable *only* to interest on indebtedness incurred or continued to purchase or carry property held for investment. Thus, interest incurred on funds borrowed for other purposes such as a home mortgage, installment purchases, consumer goods and personal or student loans would not be

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 (26 U.S.C.) (the "Code"), as amended and as in effect for the tax years 1979, 1980, and 1981.

> affected by the limitation. *In addition, interest on funds borrowed in connection with a trade or business would not be affected by the limitation. . . . Income or capital gains derived from the conduct of a trade or business are not to be considered investment income.* [H.R. Rep. No. 413, 91st Cong. 1st. Sess. pt. 1 (1969) at p. 73. (Emphasis added.)]

Section 163(d)(3)(B) specifically provides, as the quoted passage from the Committee Report states, that income and capital gains derived from the conduct of a trade or business are not investment income. This provision negates the Government's argument, since it would make no sense to exclude capital gains derived from a trade or business from the definition of investment income if, as the Government argues, the interest expense incurred with respect to such capital gain property used in a trade or business were considered investment interest. The fact that income and capital gains derived from the conduct of a trade or business are not investment income confirms that it is not the character of the gain, but the nature of the activities, which determines whether the interest expense is subject to the section 163(d) limitation.[2] The exception for interest expense incurred in a trade or business is provided because there is no logical reason to treat interest expense incurred in a trade or business differently from other expenses incurred in a trade or business.

The change made to section 163(d) by the Tax Reform Act of 1976 to eliminate the deduction of investment interest against long-term capital gain from the sale of investment assets (Pub. L. No. 94-455, §209(a)(1)) has no bearing whatsoever on the issue of how a person who is engaged in a trade or business should be treated, nor does it affect the determination as to whether a person is an investor or is engaged in a trade or

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[2] If Congress had meant to limit the deduction for interest expense incurred to purchase or carry capital assets, it could have used that term in the statutory definition of "investment interest" or it could have so stated in the legislative history. *Compare* section 165(c)(1), (2) and (3) *with* section 165(f) and (g). *Cf.* section 170(b)(1)(C). This Congress did not do.

business. The Committee Report accompanying this change makes it clear that the exclusion from section 163(d) of interest incurred in a trade or business was not affected by the 1976 change. H.R. Rep. No. 658, 94th Cong., 1st. Sess. (1975) at pp. 103 n. 1 and 104.[3]

In its brief, the Government attempts to represent petitioner's position as contending that a full-time investor in the stock market is in a trade or business. (Brief in Opp. at p. 13.) Yet, as the Government knows full well (and as clearly set forth in the Petition at p. 12), petitioner agrees that an investor in the stock market is not engaged in a trade or business, regardless how extensive his activities. The question presented in this case, however, is whether the full-time speculative buying and selling activities of Louis Yaeger were so extensive that they constituted a trade or business and not those of an investor. By restating petitioner's position, the Government seeks to avoid dealing with the question of the validity of the judicially created requirement adopted by the courts below that one must profit from short-term swings in the market in order to be in a trade or business.

The Government erroneously denies that the decision of the Second Circuit below conflicts with the Fourth Circuit's decisions in *Commissioner v. Nubar*, 185 F.2d 584 (1950), *cert. denied* 341 U.S. 925 (1951), and *Adda v. Commissioner*, 171 F.2d 457 (1948), *cert. denied* 336 U.S. 952 (1949), on the grounds that those cases did not involve the limitation on the deduction of interest expense contained in section 163(d) but concerned whether a non-resident alien who was actively engaged in buying and selling securities was engaged in a trade or business in the United States. (Brief in Opp. at p. 15, n. 10.)

The Government's assertion that *Nubar* and *Adda* should, in effect, be ignored by this Court is quite startling. Since none

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[3] As originally proposed, the House Amendment to section 163(d) in 1976 expanded the interest limitation to all "non-business" interest (*i.e.*, personal and investment interest). This further indicates a Congressional intention not to place any limitation on interest expense incurred in a trade or business. H.R. Rep. 658, *supra*, at 103-105.

of the cases upon which the Government relies involves the precise issue of "trade or business" under section 163(d), the fact that neither *Nubar* nor *Adda* deals with that precise issue can hardly be deemed proper grounds for ignoring them.

Moreover, the source of all of the confusion in the law – and the case on which the Government and the courts below rely – *Liang v. Commissioner*, 23 T.C. 1040 (1955), involved the identical issue as in *Nubar* and *Adda* – *viz.*, whether a nonresident alien was engaged in a trade or business in the United States within the meaning of section 211(b) of the 1939 Code.

In sum, the Commissioner cannot explain away the results of the Court of Appeals cases decided after the Supreme Court's decision in *Higgins v. Commissioner*, 312 U.S. 212 (1941), *i.e.*, *Fuld v. Commissioner*, 139 F.2d 465 (2d Cir. 1943), *Levin v. United States*, 597 F.2d 760 (Ct. Cl. 1979), *Nubar* and *Adda*, which, on substantially similar facts, support the Estate's position that seeking to profit from short-term swings is a factor to consider, but is not a requirement which must be met in order to be engaged in a trade or business. On the other hand, the cases which the Government cites involved facts which would not demonstrate trade or business status even without consideration of a short-term holding factor. The courts in those cases were not required to and did not focus on the issue of whether lack of short-term holding alone would be sufficient to deny trade or business status where all the other facts indicate trade or business status. Even *Moller v. United States*, 721 F.2d 810 (Fed. Cir. 1983), *cert. denied*, 467 U.S. 1251 (1984); and *Purvis v. Commissioner*, 530 F.2d 1332 (9th Cir. 1976), upon which the Government relies, support the Estate's position in this regard.

* * *

The second question presented by petitioner relates to the jurisdiction of the United States Tax Court to determine a deficiency in income tax with respect to the tax year ended May 11, 1981, even though that year is nowhere mentioned either in the notice of deficiency issued by the Commissioner, the petition

filed with the Tax Court by the taxpayer or the answer to the petition filed by the Commissioner. Pursuant to Rule 22.6 petitioner wishes to call to the Court's attention this Court's recent decision in *United States v. Dalm*, ____ U.S. ____, 110 S. Ct. 1361 (March 20, 1990), which was rendered after petitioner filed its petition for writ of certiorari.

In *United States v. Dalm*, this Court emphasized the paramount importance in tax cases of strict compliance with the statutory provisions which confer jurisdiction. In reversing the Sixth Circuit Court of Appeals, the Court held that the district court could obtain jurisdiction only if the specific statutory requirements were met, notwithstanding the compelling equities involved in that case to expand the district court's jurisdiction. In the instant case, the United States admits in its brief in opposition (Brief in Opp. at pp. 8-9, 17) that the notice of deficiency issued by the Commissioner sets forth an incorrect taxable year and that it fails to set forth the taxable year which the Commissioner says he wishes to litigate in the Tax Court. Simply put, the Commissioner has failed to comply with the provisions of the Internal Revenue Code which limit the jurisdiction of the Tax Court to determine tax liability to the year or years set forth in the notice of deficiency. (See sections 6212, 6213 and 6214.)

In *United States v. Dalm*, this Court determined that jurisdiction must be conferred by statute and is not gained by relying on equitable principles. In the instant case, the Tax Court correctly held that it does not have jurisdiction to determine a deficiency with respect to a taxable year which is nowhere set forth in the notice of deficiency, or in the pleadings. The Commissioner seeks to avoid the effects of his erroneous notice of deficiency and of the fact that the statute of limitations for issuing a correct notice of deficiency has expired, by simply having the court order, by fiat, that the Tax Court has jurisdiction over a different taxable year. This Court should reverse the decision of the Second Circuit Court of Appeals which granted (indeed imposed) jurisdiction on the Tax Court for a taxable year not set forth in the notice of deficiency.

CONCLUSION

For these reasons and for those set forth in the petition, it is respectfully submitted that the petition for a writ of certiorari should be granted.

Respectfully submitted,

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